Catch the wind behind insurance

Helios presents an interesting opportunity in a sector paying dividends for investors

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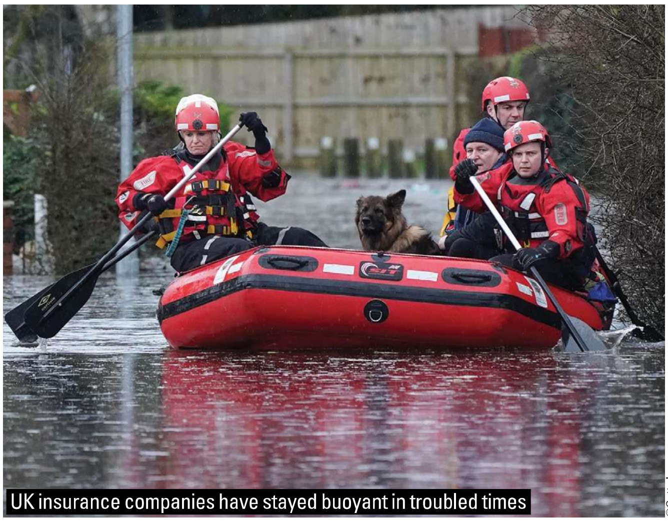

UK insurance companies have stayed buoyant in troubled times

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The UK's insurance industry is one of its most underappreciated assets. The City of London is home to the world's largest concentration of insurance companies, which have evolved around the central pillar that is Lloyd's of London. And while the rest of the UK economy might be struggling with global economic headwinds, the insurance industry is going through one of the most exciting bull markets in recent memory.

Double tailwind

Towards the end of the last decade, pricing discipline across the industry collapsed, thanks in part to over-competition. However, after a string of disasters and huge losses, growth in premiums began accelerating around 2020. Soon afterwards, insurers were handed another windfall in the form of rising interest rates.

All insurance companies have to maintain large reserves to pay out in the event of claims. These reserves are usually invested in bonds, and the returns from the portfolio add to the company's overall results. As interest rates and bond yields have risen, so have returns from insurers' investment portfolios. When combined with rising premiums, the sector is currently benefiting from a double tailwind.

The three main-listed Lloyd's insurers are **Lancashire (LSE: LRE), Beazley (LSE: BEZ)** and **Hiscox (LSE: HSX).** Lancashire set the tone for the sector's positive performance in November last year when the company announced a capital return of $169m, including a special dividend of $119m (41p per share) and a share buyback of $50m. Lancashire had a history of paying large special dividends to investors but stopped in 2016 (barring one small special payout in 2018) when the sector entered a downturn.

Beazley was the next company to announce extra cash returns. As a result of better-than-expected claims during the year, the firm announced a $300m share buyback at the end of February – 5% of its market value. Considering these trends, Hiscox seems likely to announce bumper cash returns when it publishes its results on 5 March.

Improving fundamentals

Helios Underwriting (Aim: HUW) is a fraction of the size of Lancashire, Hiscox and Beazley, but as a way to build exposure to this cyclical upswing in the insurance market, it presents an interesting opportunity. The opportunity exists for structural and accounting reasons. Helios is a £101m Aim-listed holding company for Lloyd's of London underwriting vehicles. It has been buying up these vehicles from the wealthy individuals that have historically backed the Lloyd's market, as well as growing organically.

Technically, it operates around the same framework as Beazley, Hiscox and Lancashire, with one key difference in the way it accounts for profits. The three big players report results using generally accepted accounting principles (GAAP), which means potential profits are recognised earlier.

Helios uses the standard three-year accounting time frame that has long been the staple of Lloyd's private capital providers. In effect this means Helios's performance will lag the rest of the market. However, we can see where the company's profits are going based on the results of its peers.

The company's performance has been overshadowed by high costs relating to acquisitions and financing. Its valuation has also suffered from large stake sales by major investors. Odey Asset Management, formerly one of the firm's biggest supporters with a 10% stake, was forced to dump 1.1 million shares following the founder's fall from grace in 2023. Another large investor, Hudson Structured Capital Management, which currently holds 16% of the business, had to sell one million shares to raise cash following the collapse of one of its holdings, Southern Fidelity Insurance Company.

We cannot rule out further sales by these investors. However, over the coming years, improving fundamentals should start to take over from structural market issues. As the favourable performance of the Lloyd's market starts to feed through the three-year cycle, Helios is set to report a profit before tax of £14.9m for 2023, according to Edison. That figure is expected to rise to £25.8m in 2024 and £37m in 2025.

Deep-value play

In October, management raised its annual base dividend from 3p to 6p (due to the cyclical nature of the industry, insurers like to pay low base dividends and top them up with special dividends). It has also been buying back shares and has continued to do, renewing the facility in December.

Helios is expected to increase its dividend meaningfully in the years ahead as profits work their way through the system. The dividend could rise to 18.4p per share in 2025 according to Edison, offering a 12.4% yield on the current share price.

Readers may doubt the reliability of these attractive forecasts, especially in an industry where one large loss can wipe out years of profit – though Helios reinsures a percentage of its exposure to minimise losses.

Another way to value the firm is to use book value. Every year investors can trade their exposure to Lloyd's syndicates via the market's annual auctions. The price achieved in these auctions gives investors a rough idea of how much their exposure is worth. Helios has used the figures to compute the value of its exposure. When combined with potential profits and other assets, the firm's net asset value was 176p at the end of September. This figure is expected to rise meaningfully as profits materialise, but even now, at 136p the stock is selling at a deep discount to this value.

Helios Underwriting (Aim: HUW)
Share price in pence